The same point is repeated on p. 70 as evidence that the FAS 106 cost change is not significant.

The DRA is correct that the adoption of FAS 106 will not change economic costs for Pacific Bell or for any other firm in the economy. Economic costs in the economy have always reflected the present value of expected future PBOP expenditures as part of the cost of labor. In the unregulated part of the economy, output prices, thus, always reflected accrual accounting costs for PBOPs. Firms with which Pacific Bell competes in the labor market recognize the economic costs of hiring a worker, and unregulated firms with which Pacific Bell competes in telecommunications services markets base their output prices on economic costs, a component of which are measured by accrual accounting costs for PBOPs.

Thus adoption of FAS 106 would disproportionately affect regulated utilities because only regulated utilities, and some government contract purchases (what we called the "cost-plus" sector in our earlier submission), currently set their prices on the basis of cash accounting for PBOPs.

C. The cost change must not be captured in the GNP-PI.

The DRA did not address the analysis we presented in our previous report.[9] Our reasoning was straightforward. Firms in the unregulated sector will initiate no price increase due to FAS 106. Firms in the "cost-plus" sector comprise about 10.5 percent of GNP and are assumed to experience the U.S. average PBOP expense

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[9] W.E. Taylor and T.J. Tardiff, op. cit., Section III.

increase of 1.1 percent. By simple arithmetic, the net effect of FAS 106 on national output prices could be no higher than 0.12 percent.[10] Pacific Bell estimates the total revenue requirement effect on Pacific Bell from FAS 106 to be 2.61 percent. Thus, the increase in GNP-PI from FAS 106 would account for 0.12 percent which would leave 2.49 percent (2.61 less 0.12) to be picked up by the Z-factor adjustment.

The DRA does claim (on p. 69) that the price cap formula would double-count for medical price increases because the GNP-PI contains a health care component. This error was addressed on pp. 15-16 of our earlier paper. Basically, the DRA is confusing input prices and output prices.

First, this claim mis-states the price cap formula:

> "...the Price Cap Formula under the NRF includes an allowance for increases in retired and active employee medical cost. This constitutes some degree of rate recovery under the Price Cap Formula," (p. 69).

To the extent that these increases affect the rate of growth of GNP-PI, they result in potential rate increases under the NRF. However, the Z-adjustment for SFAS 106 is a one-time adjustment, based on forecasts of future medical expenses. Once the plan is in place, actual increases in medical costs will not result in additional rate recovery through a Z-adjustment.

Second, equation (3), p. 9 of our previous paper

$$dp = dp^N - [\ dTFP - dTFP^N + dw^N - dw\ ] + [\ Z^* - Z^{*N}\ ]$$

[10]This calculation ignores second-order effects that would lower the impact on national output prices. As prices rise in the cost-plus sector, for example, consumers substitute away from those goods and services which reduces the net effect on overall inflation.

shows that the California NRF price adjustment formula is constructed so that if Pacific Bell meets its productivity target X and all forecasts go as planned, its output price will have to be multiplied by [1 + GNP-PI - X + Z] every year to keep prices equal to costs.

D. The cost change must be significant.

The DRA concedes that the change in accounting costs is significant (p. 70). Since the initial prices for the NRF were set using cash accounting costs for PBOPs (p. 69), the price change necessary so that initial prices for the NRF would use SFAS 106 expenses would be significant, "compared with the overall costs of the utility."

E. The impact must be determinable with reasonable certainty and minimal controversy.

The DRA has taken this requirement from the Phase II Order out of context. The "reasonable certainty and minimal controversy" phrase is the standard for proposing rate recovery for exogenous cost changes that will occur during the upcoming year. The SFAS 106 Z-factor is not of this type. It is not the case that at the end of the upcoming year, historical data will reveal what the cost change due to implementation of SFAS 106 actually was. Rather, the cost of PBOPs has already been incurred. SFAS 106 provides an agreed-upon actuarial method to estimate the economic costs of those PBOPs. Since it depends on future costs, the estimate will be uncertain, but the economic cost for PBOPs incurred in the current year will be known as accurately at the beginning as at the end of the year.

IV. PRICE CAP IMPLEMENTATION

On page 76, the DRA implies that implementation of Z-factor treatment for FAS 106 changes would increase the degree of regulatory oversight because

> "The PBOPs revenue requirements are just too large, the costs just too speculative, and ability to divert funds to nonPBOPs and nonregulated uses are just too great for DRA's safeguards not to be adopted."

On the contrary, Pacific is proposing a one-time Z-factor adjustment that would bring prices into line with their level had the NRF begun under accrual accounting for PBOPs. There would be no future forecasts of PBOP expenses, no annual Z-factor adjustments for PBOPs, no reliance on ratepayers to make up for underestimated PBOP expenses, and no refund to ratepayers for overestimated PBOP expenses. In such a plan, there is no regulatory second-guessing; Pacific Bell's rates are adjusted once, and from then on, Pacific must manage its PBOP expense in the same manner that it manages other expenses under the NRF.

PBOPs are one component (along with wages and pensions) of a worker's overall compensation package. Thus, the treatment of PBOP expenses under price caps cannot differ significantly from the way in which changes in wages are treated. Under the NRF, changes in wage rates are not exogenous cost changes to be passed through to ratepayers. Rather, increases in input prices affect Pacific Bell prices only indirectly through the price cap formula subject to the productivity target.

V. DRA'S ARGUMENTS THAT PAYGO FUNDING IS THE MOST ECONOMICALLY SOUND MECHANISM IS BASED UPON AN ERRONEOUS FOUNDATION.

The DRA endorses the currently used pay-as-you-go (PAYGO) funding mechanism, based upon its claim that this type of funding is the most economic. In DRA's view, minimizing costs to current ratepayers is apparently the overriding consideration in assessing the economics of a particular course of action.

> "Economics clearly dictate that PAYGO is the most efficient approach and provides the most benefits to ratepayers. DRA's quantitative analyses demonstrate that 1) pay-as-you-go funding is the most economically sound and justifiable approach ... 2) prefunding is not as cost effective (on a net present value basis) as pay-as-you-go funding ..., and 3) nontax-deductible prefunding is uneconomic and unsound." (p. 20)

Although there is no disagreement that economic efficiency dictates that utilities should provide services to ratepayers at the lowest possible cost, this does not imply that lower bills over a period of time are a necessarily better outcome than higher bills. If the lower bills are the result of ratepayers avoiding some of the costs of the services that they have consumed, economic efficiency is not served. The ratepayers do benefit, but this benefit occurs at the expense of either the utility's shareholders and/or future generations of ratepayers, who cover the deferred charges through reduced earnings and/or in the prices paid for services.

In the case of the costs associated with post-retirement benefits, the shift to accrual accounting is a recognition of (i) costs that have already been incurred for services provided in the past, and (ii) the true level of costs incurred today to provide current service.[11] Under cash (PAYGO) accounting, the current ratepayer pays through PBOP expenses for labor services provided in the past.

Viewed in this light, the DRA's argument can be recast as follows. For any given period of analysis (20 to 25 years in DRA's Appendix 4), it is always better to shift some of the recovery of costs already incurred beyond the period of analysis. While this approach is bound to produce lower net present values of prices paid by current ratepayers, it says nothing about the underlying economics of the funding decision.

The DRA's argument here is sometimes applied to depreciation, where long depreciation lives--particularly those that exceed the period of analysis--can lead to lower prices paid by ratepayers on a present value basis. Their reasoning would lead to the erroneous conclusion that long depreciation lives are always better than short lives. However, as the Commission has recognized, appropriate depreciation policies align cost recovery with economic costs even though such economic depreciation does not necessarily provide the lowest present value of expected costs to ratepayers. Accrual accounting for PBOPs serves the same purpose.

While any departure from economic costs sends the wrong signals to ratepayers, the adverse consequences are much greater when a utility faces growing competition. In the case of a monopoly utility, the inappropriate deferral of cost recovery produces prices that are too low early on, but too high later. These price

[11]PBOP expenses under accrual accounting will have two components (1) an amortization of the historical obligation that arose from providing services in previous years and (2) the currently accruing obligation associated with the currently employed labor force. The first component can be viewed as unfunded deferred compensation for labor expenses incurred for services already consumed by ratepayers.

signals will cause too much service to be consumed in the earlier period and too little later on. However, for the amount of service provided in each period, there is no reason to believe that the utility's incentives to produce efficiently are distorted.

While the inefficiencies from inappropriate timing of cost recovery have always been a serious concern in regulation, the stakes become much higher with competition. There are two reasons for this observation. First, since true economic costs play a crucial role in the terms and conditions for competition, any deviation from true economic cost in the measurement of the incumbent utility's cost can distort the competitive process. For example, if the price floors for competitive services are based upon inappropriate cost recovery assumptions, they could be too low in an early period and too high later on. Such an outcome could frustrate the objective of the most efficient firm being able to provide competitive services.[12]

Second, with competition and incentive regulation, the Commission can no longer guarantee deferred recovery of costs. In particular, the utility is at risk for the recovery of the historical liability under incentive regulation. Failure to adjust price ceilings to offer the utility the opportunity (1) to cover these historical costs and (2) to recover the economic costs of ongoing operations under competition raises the real possibility that the utility will never fully recover legitimately incurred costs of service.

Therefore, the one-time adjustment proposed by Pacific is best viewed as a mechanism to align starting prices more closely with economic costs and to provide a less risky method for the recovery of deferred historical costs. The proposal provides

[12]The incremental cost for a given service includes as a labor component, the accrued PBOP expenses associated with the labor needed to provide that service, but it does not include any of the historical costs that arose from deferring recovery of costs associated with previously provided services.

a one-time adjustment to align the initial rates under price caps to the just and reasonable standard that is the fundamental basis for price regulation.

Finally, we note that the DRA appears to rely on an analysis by Salomon Brothers, Inc. (Appendix 3) as support for their conclusions on the superiority of PAYGO funding. The Salomon Brothers' analysis actually supports a very different conclusion. The analysis considers the hypothetical example of how to fund a new obligation to provide $1,000 of health care in 15 years.[13] Of the vehicles considered, PAYGO funding was only as good as a VEBA which is not collectively bargained (and therefore, whose earnings are not tax-sheltered).[14] Vehicles that allow tax-sheltered earnings (collectively bargained VEBAs and 401(h) accounts) are clearly superior to PAYGO funding in the Salomon Brothers' analysis.

VI. SEVERAL CLAIMS MADE BY THE DRA ARE INCONSISTENT WITH SOUND ECONOMICS AND THE BASIC PRINCIPLES OF INCENTIVE REGULATION.

Several of the DRA's recommendations do not make economic sense for a telephone company regulated by means of a price cap formula and participating in

[13]Thus, the analysis addresses the economics of funding new obligations, but provides no analysis of how to treat the historical liability.

[14]In a somewhat different context, the DRA actually came to the same conclusion that the timing of cost recovery does not affect the magnitude of the cost. "To the extent current costs are capitalized as a regulatory asset, such costs do not flow through the income statement. In other words, the greater the amount of SFAS No. 106 costs that a utility capitalizes as a regulatory asset under SFAS 71, the smaller the current impact of SFAS No. 106 on the utility's net income. Later, as PBOPs costs recognized for ratemaking purposes exceed SFAS No. 106 costs, the process will reverse itself. The net result is only a change in the timing of the recognition of SFAS No. 106 costs, and not in the amount of costs." (p. 26).

competitive markets. Inappropriate regulation of PBOPs interferes with management's ability to control costs under NRF and unfairly burdens future ratepayers with the costs of current services.

A. The DRA's attempt to distinguish PBOP funding from pension funding does not alter the fundamental economic equivalence of these two types of deferred compensation[15].

The DRA argues that because PBOP funding differs from pension funding in legal aspects, implementation rules, financing mechanisms, and the degree of uncertainty in the size of the obligation, PBOP expenses should somehow be treated differently. In terms of the fundamental regulatory objective of aligning rates with costs, the differences enumerated by the DRA are irrelevant. The important point is that both pensions and PBOPs have come to be recognized as a form of deferred compensation that employers undertake to provide. In both cases, the economic costs are incurred at the time the obligation is incurred. The evolution of the law and regulations that govern this obligation cannot change the fundamental economic reality behind the obligation.

Similarly, differences in the degree of uncertainty about future costs do not change the fundamental economic similarity of pensions and PBOPs. In fact, the situation under price caps is no different than for any other cost component, e.g., direct labor versus the cost of network equipment. It would be ludicrous to treat these items differently under price caps just because they have different degrees of

[15]"Over the course of the FASB's deliberations on this subject, a consensus of the accounting and financial professions and in the business community concluded that PBOPs constitute deferred compensation, whereby an employer promises to exchange future benefits for employees' current services." (DRA report, p. 8).

uncertainty attached to their actuarial cost estimates. Different treatment of PBOP and pension expenses makes no more sense.

Uncertainty simply makes the calculation of the expected costs more difficult. However, the calculation is not so difficult as to prevent the unregulated world from using these estimates every day to determine the appropriate compensation package of wages, pensions, and PBOPs. Pacific's submission recognizes these difficulties, and it provides a reasonable and conservative estimate of the costs.

B. Contrary to the DRA's claim, adoption of FAS 106 for ratemaking purposes will not create market distortions

DRA makes the rather extreme claim that adoption of FAS 106 for ratemaking will distort the market.

> "...DRA has concluded that the adoption of SFAS No. 106 could result in severe market distortions because regulated monopolies would be assuming a market leadership role for an unresolved, controversial, and far-reaching issue. Without having withstood the test of the competitive market place or having received public sanction via legislative debate, monopolies' demands may not reflect prevailing economic realities and may be out-of-touch with the nation's current social/political priorities." (p. 30 -31).

This statement reveals a fundamental misunderstanding of basic economics; and, in fact, is precisely opposite the actual situation. The prices of unregulated firms already reflect the true economic costs of the PBOP obligation.[16] The prices for utilities, on the other hand, do not reflect economic costs because of the use of cash

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[16]Modern finance theory as well as practicing financial analysts recognize that accounting changes do not change the underlying economic reality. For example, in discussing the ramifications of FAS 106, Solomon Samson of Standard & Poor observed, "The realities do not change simply because someone puts down a different number. Part of our trade is adjusting published numbers to reflect economic realities." (BNA Pensions and Benefits Daily, September 27, 1991.)

accounting. Therefore, rather than leading the market, the adoption of accrual accounting for ratemaking is belated recognition of an economic fact that the market has long recognized.

C. The DRA erroneously claims that adoption of FAS 106 for ratemaking purposes will cause economic inefficiencies.

The DRA claims that "adoption of SFAS No. 106 for ratemaking purposes will result in huge increases in economic inefficiencies as ratepayer costs triple or quadruple with no increase in worker productivity or in the efficient provision of benefits." (p. 33). This claim is incorrect. Adoption of Pacific's recommendation will result in a one-time Z-adjustment of 2.49 percent, not a tripling of rates. As the financial authorities quoted by DRA recognize, adoption of FAS 106 will have a minimal impact on unregulated firms because there is no impact on the true economic costs of employing labor. Likewise, adoption of accrual accounting for ratemaking will not change the utility's economic costs; therefore, there will be no change in how efficiently the utility deploys labor. What adoption of accrual accounting will change is the timing of cost recovery, not the way in which costs are incurred.

D. The DRA fails to address the issue of intergenerational equity

Once the fundamental fact that PBOPs are a form of deferred compensation is recognized, the principle of cost causation implies that PBOP costs should be paid by the ratepayers whose demand required the associated labor expenses. To defer recovery in rates to the time at which the deferred compensation is actually paid to the retired employees represents an attempt to subsidize current ratepayers at the expense of future ratepayers. Even when the utility is a regulated monopoly, accrual accounting is consistent with both economic efficiency and equity objectives.

When competition is present, as in the case of telephone utilities, the stakes become much higher, as we discussed earlier. With competition and incentive regulation, the Commission may no longer be able to guarantee deferred cost recovery. In this case, current ratepayers would be subsidized at the expense of the utility's shareholders, thus making investment less attractive and more risky.

CERTIFICATE OF SERVICE

I, Alex Kositsky, certify that the following is true and correct:

I am a citizen of the United States, State of California, am over eighteen years of age, and am not a party to this proceeding.

My business address is 140 New Montgomery Street, San Francisco, California 94105.

On January 21, 1992, I caused the enclosed REBUTTAL TESTIMONY OF PACIFIC BELL (U 1001 C) in I.90-07-037 and Related Proceedings, to be served on all parties on the attached Service List for I.90-07-037. True copies of this document were placed in envelopes addressed to the parties as indicated on the attached service list. The envelopes were then sealed and deposited with Airborne Express in the City and County of San Francisco, State of California, for overnight delivery to the parties.

Executed this 21st day of January, 1992, at San Francisco, California.

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By: ______________________
Alex Kositsky

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the matter of post-retirement benefits other than pensions.	I.90-07-037 (Filed July 18, 1990)
Application of Pacific Gas and Electric Company for authority among other things, to increase its rates and charges for electric and gas service. (Electric and Gas) (U-39-M)	Application 88-12-005 (Filed December 5, 1988)
And Related Matter.	I.89-03-033 (Filed March 20, 1989)

REBUTTAL TESTIMONY OF DENNIS W. EVANS

ON BEHALF OF PACIFIC BELL (U 1001 C)

January 21, 1992

REBUTTAL TESTIMONY OF DENNIS W. EVANS

I.90-07-037- Phase II

1. Q. Please state your name and business address.

A. My name is Dennis W. Evans, and my business address is 140 New Montgomery Street, San Francisco, CA 94105.

2. Q. Are you the same Dennis Evans who submitted testimony in this proceeding on November 15, 1991?

A. Yes, I am.

3. Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to certain points raised by the Division of Ratepayer Advocates in their new Phase II Testimony titled "Report on Statement of Financial Accounting Standards No. 106", dated November 15, 1991. Specifically, I will respond to:

1) DRA's position that SFAS No. 106 not be adopted for ratemaking purposes (DRA pp. 30, 76), and that funding PBOP costs which are not tax-deductible simply makes no sense (DRA p. 76).

2) Clarify Pacific's position regarding the utilization of SFAS 71 to reflect as a regulatory asset the portion of SFAS 106 costs which may not be recovered in rates (DRA, p.30).

3) DRA's recommendations that: PBOPs accounting and reporting be separated between regulated and non-regulated operations; segregated accounting for active and retiree benefits as well as for active and retiree PBOP prefunding be established; plan design changes and coverage changes, as well as legislation affecting PBOP's be reported to CACD and DRA. (DRA, p.76).

PACIFIC'S RESPONSE TO DRA'S POSITION THAT SFAS NO. 106 NOT BE ADOPTED FOR RATEMAKING PURPOSES AND, UNDER ANY FUNDING SCENARIO, FUNDING WHICH IS NOT TAX DEDUCTIBLE IS INAPPROPRIATE.

4. Q. Do you agree with DRA's summary statements on page 76 that "SFAS No. 106 should not be adopted for ratemaking purposes" since "...paygo is the most cost-effective option for funding PBOP's obligation while full funding of SFAS No. 106 is the least cost effective option."?

A. No. Pay-as-you-go understates the actual cost of providing utility service. DRA's suggestion takes an overly simplistic approach that today's ratepayers would be better off by not paying the economic costs for utility services; however, the real issue to be considered in this proceeding is not the absolute level of rate increase. Rather the issue should be, as a matter of fairness, whether utilities are entitled to recover the economic costs of providing service. As Dr. Taylor noted on page 3 of his Economic Analysis Of The DRA's Testimony, "...expenses recognized under accrual accounting for PBOPs are consistent with economic costs, while PBOP costs recognized under cash accounting are not" and, "If adopted for ratemaking purposes, the change from cash to accrual accounting in these markets [regulated] would move prices towards economic costs and remove the intergeneration inequities embodied in the current price structure." I am concerned that DRA fails to consider the fact that, to date, rates have not covered the economic costs of PBOPs. Furthermore, DRA's proposal is unsound from both an economic and regulatory policy perspective in that it continues to push recovery of these costs onto future generations of ratepayers.

5. Q. DRA also states that funding PBOP's costs which are not tax deductible makes no sense and should be rejected for rate making purposes. Please respond.

A. Pacific is aware that SFAS No. 106 will produce revenue requirements that exceed the company's ability to invest in tax deductible funding. Specifically, as I stated in my previously filed comments of November 15, 1991, Pacific's annual rate request is $195M (see also Attachment A to this rebuttal testimony).

The portion of this $195M rate request that is tax deductible under IRS rules is $139M as shown on Attachment B of this rebuttal testimony. This difference is substantial and failure to recover the difference in rates would deny Pacific the opportunity to recover its economic costs of providing telecommunications service.

6. Q. Other parties have suggested that funding at the tax deductible limit may be appropriate for rate recovery. What is Pacific's position on this issue?

A. Pacific believes that it should recover its actual cost of providing PBOPs to its employees and that these costs are best measured using SFAS 106 as prescribed by FASB. The company will be required to reflect the full impact of SFAS No. 106 on its financial statements. If less than full recovery is granted, Pacific would have to recognize a net income reduction, unless the Commission could guarantee future recovery of this unrecovered amount.

However, should the Commission decide to limit rate recovery to the tax deductible level, it would be adopting a less desirable, but less controversial approach that would recognize the following points:

- Recovering only tax deductible funding removes the controversy surrounding the gross-up for income tax on the portion of the PBOP expense not immediately tax deductible.

- Recovery of tax deductible funding is consistent with the PBOP recovery rationale found reasonable in Phase I of this proceeding. (D. 91-07-006 pp. 45, 48, 49)

- Recovering only tax deductible funding eliminates any inference that a revenue increase could be used for purposes other than the payment of post retirement benefits. The revenue stream would only be used to fund a qualified trust specifically designated for the payment of retiree health benefits.

- Funding to the tax deductible level will (albeit to a lesser degree than Pacific's proposal), reduce PBOP costs and revenue requirements over the long-term as the funds residing in the trust will earn a rate of return.

- For Pacific, as a price-cap regulated company, rate recovery at the level of tax deductible funding would also eliminate the controversy surrounding the portion of SFAS No. 106 recovery already reflected in GNP-PI. The reduction from rate recovery at the full accrual level to rate recovery at the tax deductible funding level would be significantly more than any estimate of the portion of this accounting change that is reflected in the GNP-PI.

Taking into account the various positions advocated by the parties in this proceeding, Pacific views rate recovery limited to tax deductible funding as a pragmatic solution to a difficult issue. Such recovery would at least begin to allow for recovery of the shift to accrual accounting while also challenging utilities to further control their costs.

As DRA points out in its report (DRA p.23), "...the salient issue in this proceeding is not whether SFAS No. 106 is good accounting (it is), but whether SFAS No. 106 it is good ratemaking."

The FASB recognized that pay-as-you-go accounting does not reflect the true cost of an employer's benefit promise, and since California utilities' to date have had their rates tied to pay-as-you-go, a rate adjustment should also be granted with the implementation of SFAS No. 106. Thus, Pacific believes SFAS No. 106 is good accounting <u>and</u> ratemaking which should commence as soon as possible.

CLARIFICATION OF PACIFIC'S PERSPECTIVE REGARDING THE UTILIZATION OF SFAS NO. 71 TO RECOVER PBOP COSTS AS A REGULATORY ASSET

7. Q. DRA suggested, on page 30 of its supplemental comments, that Pacific's position was uncertain regarding whether it could record a PBOP regulatory asset if the Commission does not grant full recovery of SFAS 106 costs. DRA stated that "in one data request [DR-18] Pacific informed the DRA that it was speculative as to whether Pacific could record a PBOPs regulatory asset...but that in another data response [DR-07], Pacific Bell states that SFAS No. 71 is applicable to PBOPs costs, even under price cap regulation." Could you clarify Pacific's position regarding application of SFAS 71.

A. Yes. The response to the latter data request [DR-07] referenced a copy of an internal 1989 status report, prepared in the early planning stages of PBOP accrual accounting (even before implementation of the new regulatory framework and issuance of SFAS 106). Pacific now has a much better understanding of the implications of the price cap formula in the new regulatory framework. In response to the more recent data request, Pacific reflects its current position that it will be very difficult for a price cap regulated utility to invoke SFAS No. 71 for unrecovered PBOP costs.

COMMENTS ON DRA'S MONITORING PROPOSALS

8. Q. On pages 63-64 of DRA's report, they recommend "...segregated accounting treatment and reporting for regulated and non-regulated operations, segregated accounting for active and retiree benefits and prefunding; reporting of plan design changes and coverage changes, reporting of legislation effecting PBOP's and the recommendation to establish separate accounts to record rate recovery." What is Pacific's reaction to these recommendations?

A. Pacific believes that DRA's recommendations are unnecessary.